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Many Happy Returns: Guarding the Integrity of the CPP Investment Board

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Almost a decade after the reforms that partially pre-funded the Canada Pension Plan (CPP), the Plan is evolving much as their designers had hoped. Among the many features of the package negotiated in 1996/97 and implemented in 1998, the most critical was a ramping up of contribution rates faster than would have occurred under the old pay-as-you-go structure. Income from the resulting provident fund was intended to prevent contribution rates from continuing to rise as the aging baby-boom generation drove up the ratio of pensioners to contributors, instead containing rates at 9.9 percent.

This change, and parallel changes to the Quebec Pension Plan (QPP), played a key role in the restoration of Canada's fiscal health after the mid-1990s. The ratio of the CPP's unfunded liability to GDP declined with the reforms, and currently looks likely to hold steady at around 40 percent for the next decade (Figure 1). The CPP's last actuarial evaluation as at year-end 2003 (OCA 2004) showed that the 9.9 percent contribution rate should be sustainable through the lifetimes of current plan participants.[1]

This record risks distracting attention from a warning issued by some critics of the CPP's previous structure, myself among them (Robson 1996), that pre-funding alone would not solve the CPP's problems. Why? The record of government-managed provident funds around the world in serving the interests of their participants is appalling. That was true in the mid-1990s, and experience since then has added to the tales of horror. A 2000 survey found that, of 22 countries providing at least eight years of comparable data (many provident funds report no market values for their assets and some publish no results at all), only two —

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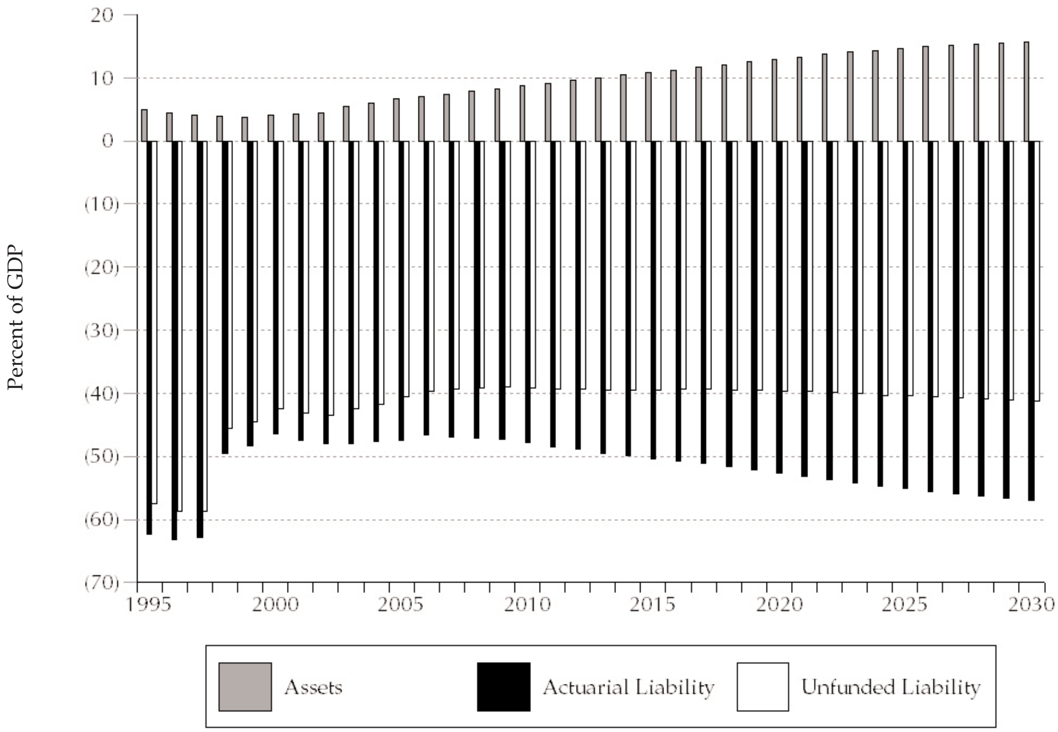
1 For the CPP — the QPP is not sustainable with a 9.9 percent contribution rate (RRQ 2005), and another similar finding will trigger a review of its provisions.

Figure 1 *CPP Assets, Liabilities, and Unfunded Liability, 1995–2030*



Note: Assets are from OCA (2004) for years to 2003, CPPIB Financial Statements for 2004 and 2005, and author's estimates based on rate of return assumptions in OCA (2004) for the years 2006-2030. Actuarial Liability is a special run from the Office of the Chief Actuary based on methods in OCA 2004, but showing figures pre-1998 consistent with plan provisions at that time.

Malaysia and Korea — earned real returns better than 3 percent. Half lost money, and some obliterated the savings of their participants.[2]

Canadian tales of such politicized investments are cautionary. From 1966, the year the CPP and QPP were established, until 1997, the last year before the reform package took effect, investing the balance between contributions and expenses of the CPP or the QPP in the median pension fund in the RBC Dexia Investor Services database would have earned a real rate of return of 5.4 percent. The actual real rate of return on net contributions to the CPP — which was constrained to lend to governments at concessional interest rates — was a mere 4.0 percent. The real rate of return on net contributions to the QPP — which was less constrained, but struggled with a dual mandate to earn investment returns and to promote economic development in Quebec, which also made it a "captive" source of government finance — was 4.6 percent.[3]

2 Zambia, Peru and Uganda had annualized losses of 31, 47, and 51 percent respectively (Iglesias and Palacios 2000).

3 These are internal rates of return on annual contributions net of outlays, as shown in the national income and expenditure accounts, using year-end 1997 net assets in the plans, as shown in the national balance sheet accounts. The Caisse de dépôt et placements, which manages the QPP's investments, has recently stressed the primacy of investment returns in its mission (CDPQ 2005, 79).

The CPP reforms' designers knew these dangers of conflicting mandates, and responded to them in the reform package (Slater 1998). Specifically, the CPP Investment Board (CPPIB), which was created to manage the Plan's new reserve funds, got a clear mandate to serve participants by maximizing returns without undue risk of loss. Its directors are selected with the collaboration of provincial finance ministers, and the board selects the CPPIB's chief executive officer. Its reporting and communications make the CPPIB a state-of-the-art example of good governance for such organizations.

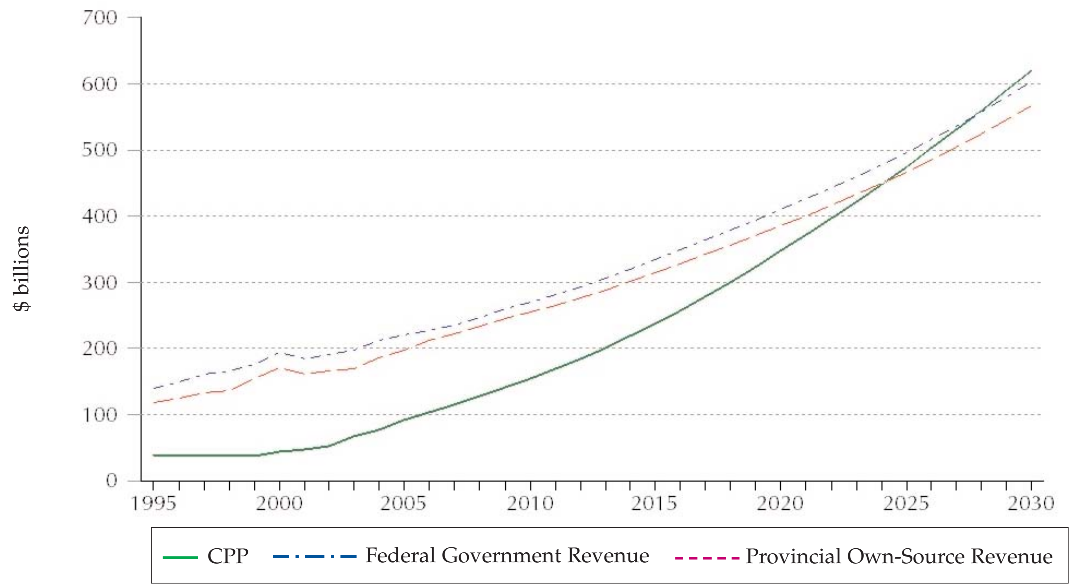
So far so good — but protecting provident funds from political direction is a task that never ends. While Canada's political culture has shown low tolerance for misappropriation of public funds for the personal gain of political leaders, the slippery slope of politicized investment starts with less obvious malfeasance. The CPPIB's own polling shows that more Canadians support than oppose investing in all regions of Canada, even at the cost of lower returns (EKOS 2003, 75). Many Canadians would likely favour steering CPPIB investments toward public infrastructure and social housing, and away from the securities of companies or countries that do things some people dislike — such as making tobacco products, or operating in parts of the world where labour and environmental standards are lower than Canada's. Pressure on the CPPIB to vote its shares to change company operating or compensation practices is also easy to imagine.

Conscious of these threats, the CPPIB is working to fend them off. It has highlighted poll results showing politicized investment as a concern for between 60 and 70 percent of Canadians (EKOS 2005, 74). It has actively set out its terms of engagement in the debate over the intersection of environmental, social and governance factors with financial performance: in March 2006, it joined the Enhanced Analytics Initiative, an international group that fosters research "that considers the impact of extra financial issues on long term company performance"; and in April, it signed the Principles for Responsible Investing published by the United Nations Environment Programme (UNEP) Financial Initiative.[4] The Board's "Policy on Responsible Investing" (CPPIB 2005) states its intention: 1/ to invest in securities of issuers whose business is (or would be) legal in Canada and are located in countries with which Canada has normal relations; and 2/ to urge better business practices through participation in coalitions and by demanding transparency from the organizations with which it deals.

This approach is not without tension, however. The opening text of the UNEP Financial Initiative (UN 2005, 4) appears clear: "As institutional investors, we have a duty to act in the best long term interests of our beneficiaries." But the second sentence thereafter — "We also recognise that applying these Principles may better align investors with broader objectives of society" — is not an unambiguous upholding of the principle that participants' interests come first. And while the CPPIB has thus far invested largely in portfolios managed by third parties and in direct investments where it exercises no governance role (CPPIB 2005, 6), keeping itself "below the radar" in this way will get harder as its holdings expand.

4 CPPIB news releases, March 27 2006 and April 27, 2006.

Figure 2 *CPP Assets and Government Revenue, 1995–2030*



Note: CPP assets are from OCA (2004) for years to 2003, from CPPIB Financial Statements for 2004 and 2005, and author's estimates based on rate of return assumptions in OCA (2004) for the years 2006-2030. Historical government revenues and GDP are from public accounts data and Statistics Canada, CANSIM; projections are author's calculations assuming constant revenue shares of GDP as projected in OCA (2004).

Even more important, the reserve fund is growing dramatically faster than other potential sources of government funds. Figure 2 uses the assumed returns in the latest actuarial report to project assets in the fund from year-end 2005 forward, and compares them to federal and provincial (own-source) government revenue on the assumption of stable ratios of tax revenue to GDP. Until recently, CPP assets were much smaller. They are now approaching half of annual government revenues, however; in another decade, they will be around three-quarters, and by the end of the 2020s, they will surpass them.

These projections and the dismal record of provident funds elsewhere add a worrisome aspect to even the benign-sounding proposal in the 2006 federal budget to tuck extra surpluses into the CPP's fund (Canada 2006, 56-57). That transaction would breach what has up to now been a solid wall between the CPP and the regular federal budget. Create a hole through which money repeatedly flows between the two, and the odds are high that one day the flow will go the other way.

When Willie Sutton, the bank robber, was once asked why he robbed banks, he famously replied: "because that's where the money is." As the CPP's provident fund grows, governments under pressure to deliver on their promises to provide healthcare, education and infrastructure to a tax-weary population will inevitably look covetously at the fund. It is not too early, therefore, for a reassertion by the CPPIB, by governments, and by concerned Canadians that the CPP's funds are for one purpose, and one purpose alone: to pay benefits to plan participants. To compromise that principle is to step on a slippery slope that, as other countries have shown, can leave pensioners at the bottom and out of pocket.

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